evolution. The video distribution media should be free to experiment with various approaches and to test consumer acceptance before standards are imposed. Mandating standards prematurely will only stifle innovation. The nation's experience with computer standards -- and the absence of government mandates over them -- teach that standard setting by government is often unneeded and counterproductive. The Commission's role here should be to monitor the conversion to digital technology to ensure that the public has access to a variety of distribution media.

B. Requiring Set-Top Decoders To Be Sold At Retail Will Endanger System Security

The Commission also asks a series of questions about the deployment of set-top boxes with advanced functionalities. Today's set-top boxes provide a variety of functions including compensating for technical deficiencies in television receivers, tuning cable channels and performing basic commands, and descrambling encrypted signals. State-of-the-art set-top boxes, such as those deployed by Time Warner Inc., will give consumers the flexibility to choose among programs and services on demand. Addressable boxes allow subscribers, for example, to order pay-per-view programming with the push of a button, to engage in two-way interactive communications, and to change their level of service with virtual immediacy.

The Commission focuses, in particular, on the potential retail availability of set-top equipment. First of all, set-top converters which provide improved tuning capability and shielding from harmful signal leakage (but do not descramble signals), have been sold at retail for many years. Set-top descramblers, on the other hand, are only provided by the cable operator (at regulated prices) because these boxes are the primary

means to control security of cable services.[6] Most cable piracy occurs through the modification of cable descramblers illegally obtained from cable system suppliers.

The cable industry today is battling a multi-billion dollar theft of service problem. Retail sale of cable descramblers would devastate the cable industry's ability to prevent signal theft by offering easy access to unlimited numbers of boxes. Indeed, decoder boxes are in such demand that armed robberies of cable warehouses are not uncommon. If cable descramblers are readily available over-the-counter, unscrupulous individuals would be able to freely purchase any number of boxes, modify them to illegally receive encrypted services, and then resell them to the public.[7]

Signals protected by digital encryption are not immune to attack. Advanced digital techniques are available today to modify and defeat cable security. And this danger is only heightened as the methods for interconnecting more advanced and powerful personal computers into large systems expand every year. In Europe, for example, television security systems that utilized digital technology and replaceable "smart cards" inserted into the descramblers were broken within months of their deployment.[8] Even though the smart card is replaceable, at a minimum of

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6 Unlike telephone companies, which protect the telephone system's security at the central office, cable companies have to protect their services at the consumer's home. This is because the signals of all programming services carried on the cable system are present and generating at all times throughout the system's distribution network.

7 While there are other methods to secure a program service, such as "negative traps" and interdiction, each possesses major reliability, signal quality and economic drawbacks that limit their usefulness.

8 Charles Platt, Satellite Pirates, Wired, Aug. 1994, at 127.

$30-$40 apiece, it would be an enormous recurring expense for cable operators and consumers to send out new cards every time the signal security is breached.[9]

Cable theft raises the cost of doing business for cable operators and programmers and, ultimately, cable consumers. Securing video programming from theft is not only important to the economic well-being of the industry, but vital to the continued investment in cable programming and cable distribution networks. Indeed, all video service providers will need to be able to control access to their services from in-home terminal devices in order to compete effectively. The Commission should not, therefore, take any steps to promote the development of a retail market for set-top boxes.

III. MARKET STRUCTURE: THE CABLE INDUSTRY HAS EXPERIENCED SOME INCREASED CONCENTRATION, WHILE VERTICAL INTEGRATION HAS REMAINED RELATIVELY CONSTANT

In assessing the state of competition, the NOI requests information on the status of the cable industry, particularly the status of horizontal concentration and vertical integration. The Commission acknowledges that a significant amount of information was provided by the cable industry for last year's report and that it can rely to a certain extent on publicly available information on these issues.

NCTA has updated the statistics on the cable industry contained in Appendix C of the 1994 Competition Report, including (1) the number of homes passed, the number of subscribers, and penetration rates; (2) systems

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[9] For example, British Sky Broadcasting did a 3 million card switchout in May 1994 at a reported cost of $15-$20 million. William Mahoney, To Catch a Thief, Multichannel News International, Apr. 1995, at 26B.

and subscribers by channel capacity; (3) industry revenue sources; (4) breakdown of cable networks by type of service; and (5) industry programming expenditures.[10] We also have updated most of the tables and information on horizontal concentration and vertical integration, as set forth in Appendix G of the 1994 Competition Report.

A. Horizontal Concentration In Local Markets

In analyzing cable's local market share, the Commission would like to develop "a picture" of what competition is like from alternative multichannel video distributors other than DBS and HSD in the local market.[11] In response, NCTA is submitting a recent case study prepared by Economists Incorporated on competition between an MMDS operator and an incumbent cable operator in Mexico City.[12]

As the dominant video provider in the Mexico City market, the cable operator was shaken out of complacency when an MMDS operator entered the market. In the ensuing competition, the cable operator had to modify its pricing policies (lowering prices, offering specials and establishing payment plans). It also had to upgrade its network and expand its service reach to previously unserved communities. As a result of increasing competition, the

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[10] See Appendix C. The Commission also asks for information on recent customer service initiatives. On March 1, 1995, virtually all of the nation's cable companies introduced an On-Time Guarantee program, which ensures consumers of (1) on-time installation appointments or installation is free and (2) on-time service appointments or the customer receives $20.

[11] NOI at ¶ 75. We submit that DBS competition in local markets should not be discounted. While DBS services may presently set prices on a national basis, they can focus their marketing efforts regionally and/or locally in response to a dominant cable operator.

[12] Economists Inc., Market Shares and Effective Competition: A Real-World Example (1995), Appendix B.

cable operator reduced its monthly service rates by over a third in a six-year period. The system still saw its market share fall from 98 percent to 34 percent, while the MMDS operator's share increased from 2 percent to 64 percent.

Meanwhile, as these companies battle it out in an expanding market, consumers are enjoying improved service quality, more channels, more diversified programming, pay-per-view offerings, and lower prices. This real-world example demonstrates that the mere presence of an alternative multichannel provider with even an initial small market share, but capable of expanding its sales, disciplines an incumbent operator well before the new entrant takes a substantial share of the market.

In questioning whether the franchise area is the relevant geographic area to evaluate local competition, the Commission acknowledges that some viewers within a franchise area may have access to competitive alternatives to cable that fall short of the number necessary to meet the "effective competition" standard in the 1992 Cable Act.[13] The Commission recognizes, nonetheless, that "cable service providers may be competitively constrained by the availability of these services."[14] It also notes that competitors in local

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[13] NOI at ¶ 76.

[14] NOI at ¶76. See TEL-COM, INC. (Petition for Reconsideration of Certification of West Virginia Cable Television Advisory Board), Memorandum Opinion and Order, 10 FCC Rcd 2114 (1995). In rejecting a cable operator's petition for exemption from rate regulation on the grounds that it served a smaller geographic area than its actual franchise area, the Commission indicated its willingness to consider marketplace solutions: "[t]here may be circumstances where a cable system, although not subject to effective competition as defined in the 1992 Cable Act, may be charging cable rates that are constrained by the presence of one or more other multichannel video programming distributors in the franchise area. . . . In such instances, the public interest may be served by relying on the market forces instead of our rate rules to ensure that the operator's rates are not unreasonable." Id. at 2116, ¶ 10.

markets may also forego price competition, and instead focus their efforts on differentiating their programming and service from those of competitors.

As we pointed out last year, the concept of "potential competition" is widely accepted by economists, antitrust scholars, the federal courts and regulatory bodies.[15] Under this principle of antitrust analysis, potential competition from firms not presently active in the relevant product and geographic markets should be taken into account in evaluating the level of competition in the market. The attached paper by Economists Incorporated explains that effective competition to cable can be provided by competitors with small or zero current market shares. This is because "the competitive significance of actual or potential competitors in a market is best measured by shares of capacity rather than share of current sales whenever a market share can expand rapidly in response to changes in price or demand."[16]

Thus, the threat of losing profits through losing sales to other firms is a primary disciplining force on the incumbent firm. Substitute products that can be made available quickly and in new markets is a major factor in assessing the impact of potential competition. As in the Mexico City example above, it is significant that a sufficient number of cable subscribers would substitute an alternative service if confronted with a cable rate increase so as to make the rate increase unprofitable.

The presence of competitors in the video marketplace (such as nationwide DBS and local wireless systems) and rivals ready to enter the

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[15] Comments of the National Cable Television Association, Inc. at 28-29, June 29, 1994.

[16] Economists Inc., Market Shares and Effective Competition: A Real-World Example at 1 (1995) (emphasis added).

market (telephone companies) acts as a constraint on cable prices and behavior.[17] And despite the relatively small overall market shares of DBS and MMDS services today, a whole host of factors are working to promote their continued success -- including government policy, technological developments, marketing strategies and joint ventures.[18] As described by Economists Incorporated, the aggregate share of alternative multichannel video services is projected to grow rapidly. The point is that the actual or imminent entry of these alternative providers in the cable market, capable of attracting a sufficient number of cable subscribers in the event of a price increase, would restrain a cable operator from raising its prices.

B. Horizontal Concentration Nationally

The 1994 Competition Report found that the national market for the distribution of cable services was unconcentrated as of the end of the first quarter of 1994. As shown in Appendix D, NCTA has calculated the Hirfindahl-Hirschman index ("HHI") for this market based on current data and finds that the cable industry is still within the category of an unconcentrated market.[19] According to our calculations, the HHI for the cable industry is 725.41. Even if all of the announced acquisitions and

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[17] United States v. Falstaff Brewing Corporation, 410 U.S. 526, 559 (1973)("[T]he existence of an aggressive, well equipped and well financed corporation engaged in the same or related lines of commerce waiting anxiously to enter an oligopolistic market [is] a substantial incentive to competition which cannot be underestimated." (citing United States v. Penn-Olin Chemical Co., 378 U.S. 158, 174 (1964)).

[18] Economists Incorporated, Market Shares and Effective Competition, at 6-15.

[19] Appendix D.

transactions in the market are consummated, the HHI would only increase to 855.37.

Although the HHI is a standard measure of market concentration, it is primarily used to ascertain the concentration of market shares among firms that compete with each other in a given market. The HHI analysis sheds light on whether one firm, or a small group of firms, has such a large share of the market that competition among them is threatened. Cable companies compete with other distribution media, but they generally do not compete with each other for subscribers or for programming. Thus, antitrust indices of market concentration, such as HHI, are not relevant to determining the cable industry's market power in the video marketplace.

Nevertheless, the industry has experienced some increased concentration over the past year. Tele-Communications, Inc. ("TCI"), the nation's largest multiple system operator, has increased its share of subscribers from 17.67 percent to 19.50 percent. Time Warner Cable has increased its share from 12.2 percent of cable subscribers to 14.51 percent. Each of the remaining top twenty cable companies serves less than 5.39 percent of the total cable households. Under the present market structure, no cable company is close to reaching the 30 percent "horizontal ownership" limit in the Commission's rules.

The trend toward consolidation in the cable industry is an inevitable consequence of the forces of competition. Cable companies are faced with ever-increasing competition from DBS, MMDS, broadcast stations -- and powerful telephone companies that are aggressively seeking to enter the video business through court rulings, regulatory initiatives, wireless acquisitions and legislation in Congress. Moreover, the imposition of complex regulatory constraints effecting the pricing, packaging and marketing of cable

services has severely weakened the cable industry's ability to obtain financing to build new infrastructures. Competitive pressures coupled with rate regulation and the lack of investment capital have driven many cable companies to merge or to be acquired by other cable companies that are preparing to compete in telecommunications.

The Commission requests comment on the competitive effects of this increased concentration of ownership, particularly "clustering" on a local or regional basis. As NCTA told the Commission when it considered imposing regional subscriber limits, clustering of cable systems brings about economies of scale and scope that facilitate innovative regional programming, enhanced customer service capabilities, and the deployment of advanced technologies.[20] Clustering also creates operating efficiencies, including cost-effective and reliable fiber backbone networks, centralized data processing centers, efficient employee training, and regional programming and advertising ventures. For instance, regional radio advertising of services which is uneconomic for one operator among many in a metropolitan market, becomes feasible in a clustered situation.

As the Commission has recognized, "clustering may result in operational and administrative efficiencies, and may also facilitate the ability of a cable operator to provide local telephone service in competition with local exchange carriers."[21]

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[20] Horizontal and Vertical Ownership Limits, Cross-Ownership Limitations and Anti-Trafficking Provisions, MM Docket No. 92-264, Reply Comments of the National Cable Television Association, May 12, 1993; see also Comments of Cablevision Systems Corp; Continental Cablevision, Cablevision Industries and Comcast Corp., Viacom International, Tele-Communications, Inc. and Time Warner Inc. in same proceeding.

[21] Cox Cable Communications Inc. and Times Mirror Company (Transfer of Control), Memorandum Opinion and Order, 10 FCC Rcd 1559, 1562 (1994); see

In regions where consolidation is occurring, companies are deploying advanced technologies, developing strategic partnerships and diversifying into new services. As noted earlier, cable companies have begun constructing "regional hubs" in order gain certain efficiencies and cost savings associated with clustering. In light of the burgeoning competition to cable, there is no evidence that regional clusters of interconnected cable systems have sent any entry-deterring signal to potential rivals. Rather, the consolidation of personnel and expertise and the sharing of expensive technology among operators in a regional hub will enable them to improve service, offer new services and compete more effectively against a variety of new video distribution sources.

C. Vertical Integration

With regard to vertical integration in the cable industry, NCTA's analysis of recent data found little change from last year's study on cable company ownership or affiliation with programming networks. NCTA has updated the following tables from Appendix G of the 1994 Competition Report, which are attached to these comments:

National Programming Services With Ownership Interests Held by Cable Operators	Table 3
National Programming Services Without A Cable Operator Holding an Ownership Interest	Table 4
Announced National Launches of Programming Services For Cable Distribution (Broken down by those with and without cable operator investment)	Table 5

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also 1994 Competition Report, 9 FCC Rcd at 7518; Second Report and Order, MM Docket No. 92-264, ¶¶ 151-53, released October 22, 1993.

Vertical Connection Between Major Programming Services and Cable System Operators — Table 7

Vertical Integration: Top Fifteen Programming Services (By Primetime Rating) — Table 8

Furthermore, if the Viacom systems, which were proposed for sale earlier this year are ultimately sold, vertical integration figures would drop significantly.

We note that in the past year, many cable networks have been launched that have no investment or affiliation with a cable MSO, including America's Talking, CineLatino, Consumer Resource Network, FoxNet, fXM: Movies from Fox, The Game Show Network, The History Channel, NewsTalk Television, and Newsworld International (See Table 4). America's Talking, which is owned by NBC, was launched with over 10 million subscribers.[22]

The Commission asks whether any programming networks have been launched or announced that are owned by cable's competitors. Apart from the broadcast networks, which have launched new services that gained carriage under retransmission consent agreements, cable's competitors are largely offering cable networks in their line-ups now that they are virtually guaranteed the programming under the program access rules.

D. Program Access

In paragraph 90 of the NOI, the Commission requests comment on whether the "program access rules" have addressed the difficulties that non-cable multichannel video providers had in obtaining programming on nondiscriminatory terms. While this question is best addressed by affected

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[22] See Appendix E (Table 4).

video providers and programmers, we believe that the "program access" rules have firmly established the ability of alternative multichannel video providers to compete in the market for cable television. The Commission further asks, however, whether these rules should be extended to non-vertically integrated program providers. For the reasons stated below, the 1992 program access mandate should not be extended to such entities.

Section 19 of the 1992 Cable Act -- and the FCC rules adopted thereunder -- prohibits vertically integrated cable operators and satellite cable programming vendors from engaging in anticompetitive behavior, such as exclusive contracts and discriminatory pricing.[23] Where a cable operator has an "attributable interest" in the programming vendor, the operator must make the programming available to any interested multichannel video programming distributor (MVPD) on "fair terms and conditions."[24]

Despite all of the attention given to the program access rules, we understand that only a dozen or so complaints have been filed under Section 19 of the Act. Moreover, only six petitions for exclusivity (or waiver) have been filed pursuant to the program access rules. The majority of these have been resolved.[25] As the Commission said six months ago:

> Our experience over the past year suggests that the program access provisions of the statute and our implementing regulations

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[23] Communications Act of 1934, §628, 47 U.S.C. §548.

[24] See Implementation of §§ 12 and 19 of the Cable TV Consumer Protection and Competition Act of 1992: Dev. of Competition and Diversity in Video Programming Distribution and Carriage, First Report and Order, 8 FCC Rcd 3359, ¶ 9 (1993).

[25] See NOI at 42, n.146 reporting that as of May 4, 1995, the Commission had resolved 12 program access cases and 7 cases were pending.

> are successfully working to achieve Congress' goal of increasing competition to traditional cable systems by providing greater access by competing multichannel systems to cable programming services.[26]

In suggesting that the rules be extended to non-vertically integrated cable operators, the Commission is proposing a solution in search of a problem.

In adopting Section 19, Congress recognized that certain types of conduct by cable programmers that are owned or controlled by cable operators can, in some circumstances, have anticompetitive purposes and effects in the provision of video programming by multichannel distributors. Specifically, Congress found that "[v]ertically integrated program suppliers . . . have the incentive and ability to favor their affiliated cable operators over nonaffiliated cable operators and programming distributors using other technologies."[27]

Section 19 also reflects Congress' determination not to prohibit conduct undertaken for legitimate, efficient and pro-competitive reasons.[28] It requires that the Commission treat exclusive contracts as a form of unfair conduct -- but only if such contracts are determined not to be in the "public interest".

More significantly, Section 19(b) prohibits conduct by only those cable programmers "in which a cable operator has an attributable interest," and Section 19(c) directs the Commission to prohibit certain exclusive contracts and discrimination only by programmers "in which a cable operator has an

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[26] Memorandum Opinion and Order on Reconsideration of the First Report and Order, FCC 94-287, 10 FCC Rcd. 1902, 1911, ¶ 18 (1994).

[27] Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, §2 (a)(5), 106 Stat. 1460, 1460 (1992).

[28] Communications Act of 1934, §628 (b), 47 U.S.C. §548 (b).

attributable interest."[29] Thus, Section 19 was intended to prevent vertically integrated programmers from acting on their unique incentives and abilities to favor their commonly owned cable operators.[30]

Whether or not program access rules should have been adopted for vertically-integrated cable systems,[31] there is no basis for the Commission to recommend extending the application of the rules to non-vertically integrated programmers. First, as the Act's legislative history makes clear, Congress limited its concerns only to vertically integrated cable systems.[32] While acknowledging that non-vertically integrated cable operators *may* also engage in anticompetitive conduct, the Senate Report stated that the scope of the program access rules was limited *only* to vertically integrated systems.[33] Noting the "explosive growth" of vertically integrated cable systems

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[29] Communications Act of 1934, §628 (b),(c), 47 U.S.C. §548 (b),(c).

[30] As the Commission has said: "a principal target of the restrictions" contained in Section 19 is the conduct of vertically integrated programmers that is intended unfairly to favor the programmers' affiliated cable operators and inflict competitive harm on those operator's competitors." First Report and Order, 8 FCC Rcd. at 3369.

[31] As indicated in other NCTA filings, vertical integration has benefited both programmers and consumers. Cable operators have provided much of the capital necessary to develop new programming; economies of scale have ensured that consumers receive a myriad of programming choices.

[32] See supra note 23. Furthermore, the Senate considered a wholesale prohibition on common ownership of content and conduit but rejected this heavy-handed regulatory approach because "it would result in a fundamental restructuring of the cable industry and the way it does business." S. Rep. No. 92, 102d Cong., 1st Sess. 27 (1991) ("Senate Report").

[33] Senate Report at 28. ("This [program access] provision is limited to vertically integrated companies because the incentive to favor cable over other technologies is most evident with them.")

nationwide, the House Report stated that such systems reduce overall programming diversity "by threatening the viability of rival cable programming services"[34] and therefore focused its legislative efforts solely on vertically integrated systems. Since Congress saw no need to apply its program access provisions to non-vertically integrated cable systems, the Commission should not expand the scope of the rules in the absence of evidence of a need to do so.

There is no evidence to suggest that non-vertically integrated programmers have failed to provide access to MVPDs at reasonable, marketplace rates. In fact, more programming is available to MVPDs today than ever before, from both vertically-integrated and non-vertically integrated programmers. Moreover, as noted above, only a handful of complaints have been filed under Section 19 aimed at *vertically*-integrated programmer conduct. With no evidence that non-vertically integrated programmers have engaged in anticompetitive conduct (and, under Congress' theory, such programmers would have less incentive to engage in such conduct), there is no basis to warrant congressional action.

Indeed, it would be anomalous for the Commission to recommend extending the program access rules to non-vertically integrated programmers when it concluded that it was not in the public interest to apply the rules to a "technically" vertically integrated system. In deciding (correctly) not to apply its existing program access rules to the Walt Disney Company (even though it was technically covered by the rules), the Commission implicitly acknowledged that non-vertically integrated programmers do not raise the concerns raised by vertically integrated programmers. If it was in the public

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[34] H.R. Rep. No. 628, 102d Cong., 2d Sess. 41 (1992).

interest to grant a waiver to Disney because it was, in effect, not vertically integrated, it would be inconsistent to conclude that the public interest warrants extending the rules to non-vertically integrated programmers. The Commission should respect that finding and reject the suggestions to the contrary in the Notice.[35]

Finally, both the FCC and Congress have stressed their preference for marketplace solutions rather than government regulation. Under these circumstances, it would make no sense for the Commission to urge Congress to interfere with the business relationships of non-vertically integrated programmers. Some of the most widely-carried cable programming sources are not vertically integrated with cable operators: e.g., ESPN, CNBC, Lifetime, the Weather Channel, QVC, and the Disney Channel.[36] To impose regulation on companies which produce this and comparable programming would only inhibit the marketplace and redound to the detriment of consumers.

The Commission's efforts to ensure market competition in the cable television industry are admirable; however, its interest in extending the program access rules to non-vertically integrated programmers is misplaced. The legislative history of the 1992 Act demonstrates that Congress' concern

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[35] In 1994, the Commission granted the Walt Disney Company a waiver from application of the program access rules to its wholly-owned subsidiary, Madeira, which distributes programming primarily to Disney-owned hotels, despite the company's ownership of the Disney Channel. See In the Matter of Petition of Walt Disney Company for Waiver of Program Access Rules, Memorandum Opinion and Order, 9 FCC Rcd 40007, ¶¶ 4-8 (1994).

[36] See Economists Inc., Cable Network Carriage Analysis Update (attached to Comments of the National Cable Television Association, at 23, n. 66, June 29, 1994).

was with incentives and opportunities for anticompetitive conduct available only to vertically-integrated programmers. Non-vertically integrated programmers simply fail to threaten the competitive programming market. Therefore, the suggestion that the program access rules be extended to non-vertically integrated programming providers should be rejected.

IV. THE COMMISSION SHOULD RECOMMEND TO CONGRESS THAT THE DEFINITION OF "EFFECTIVE COMPETITION" BE CHANGED TO REFLECT THE IMPACT OF EXISTING AND POTENTIAL COMPETITION TO CABLE

The Commission asks for recommendations for promoting competition in the market for the delivery of video programming. First and foremost, we urge the Commission to recognize the enormous changes in the video marketplace that have brought significant new competitive pressures to cable television. As described in section one, the direct-to-home satellite industry is now a viable and rapidly growing multichannel competitor to cable, while the telephone industry is poised to become a full-fledged competitor in the near term. Indeed, the telephone companies are pursuing every legislative, regulatory and legal avenue to enable them to compete directly with cable companies.

Although these present and on-coming competitive forces are undeniable, federal law still subjects the cable industry to a very narrow definition of "effective competition".[37] Under the 1992 Cable Act, a cable

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[37] Cable Television Consumer Protection and Competition Act of 1992, Pub. L. No. 102-385, §3 (l), 106 Stat. 1460, 1470 (codified as amended at 47 U.S.C. §543 (l) (1992)). Specifically, section 623 (l) of the Communications Act requires that cable rates be regulated unless (1) at least 50 percent of the homes in the franchise area have access to a second multichannel video provider; and (2) at

system must lose a very large portion of its market share -- fifteen percent -- before complex federal and local regulation effecting the pricing, packaging and marketing of cable service is removed. This current definition is flawed because (1) it restricts the ability of the cable industry to respond to competitive pressures until individual cable companies have already lost 15 percent of their market shares and (2) it improperly emphasizes the loss of market share over the availability and viability of alternative multichannel providers.

As discussed earlier, under well-accepted economic theory, competition from entities with little or no market share but capable of expanding or entering the market cause incumbent firms to perform optimally -- to constrain prices and offer high-quality products and services. But the Commission need not rely on potential competitors to justify modification of the effective competition standard, actual competition in the form of DBS and MMDS providers exists today.

The cable industry's ability to respond to emerging competition is limited, however, by rules that restrict individual companies from making any changes in their services without federal and local regulatory oversight. In an environment where no effective competition exists, rate regulation may confer benefits on consumers that outweigh the costs, delays and inefficiency imposed by regulation. But if effective competition does exist, as in the video programming marketplace, rate regulation serves no other purpose than to impose costs and constraints on cable to the benefit of cable's competitors.

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least 15 percent of the homes in the franchise are purchase service from an alternative multichannel provider.

Moreover, regulation is occurring at a time when the cable industry wants to upgrade its systems and build the infrastructure to compete in the provision of advanced telecommunications services. Without legislative reform, the cable industry will continue to be unable to obtain the investment capital needed to upgrade their headends, complete the installation of fiber, and fully deploy digital compression technology.

Therefore, the Commission should recommend to Congress in its 1995 Competition Report that the "effective competition" definition be modified to reflect the changes in the competitive landscape over the last year.[38] Effective competition should be defined by the availability and the viability of alternative multichannel video providers, rather than be based upon an arbitrary measure of competitive market share.

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38 We continue to believe, however, that there is demonstrable evidence that multiple over-the-air broadcast signals alone can and do exert a constraining effect on cable rates. See Comments of the National Cable Television Association, Inc., at 27, June 29, 1994 citing Arthur D. Little, Inc., Evaluation of FCC Methodology for 1994 Rate Order (attached to NCTA 1994 Comments).

CONCLUSION

For the foregoing reasons, the Commission should report to Congress that a thriving video marketplace with strong competitors to cable television has arrived. The 1995 Competition Report should urge Congress to revise its definition of "effective competition" in the 1992 Cable Act to reflect these sweeping changes. Additionally, we urge the Commission not to take any regulatory action with regard to digital standards or the retail availability of set top decoder box equipment at this critical juncture in the development of these new technologies.

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APPENDIX A

MARKET SHARES AND EFFECTIVE COMPETITION

Effective competition to cable operators can be provided by competitors with small or zero current market shares. Competitors with zero current market shares are called "potential" competitors. Like competitors whose current share, while not zero, is small, potential competitors constrain the prices that can be charged by incumbent firms with large shares of the market. The competitive significance of actual and potential competitors in a market is best measured by shares of capacity rather than shares of current sales whenever market share can expand rapidly in response to changes in price or demand. This is a settled principle of antitrust analysis.[1]

For cable operators there are several sources of competition. Some, like MMDS and DBS, are already present in the market. (DBS is present today in all markets; MMDS is present today in some markets.) Video dial tone (VDT)[2] and MMDS service—in those areas where it is not already offered—constitute potential competitors. In the more distant future lies the possibility that over-the-air TV broadcasters will make use of digital compression to offer multichannel advanced video services. The following sections discuss potential competition as an economic concept, show that potential competition is widely accepted by economists and has been

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1 The importance of seeking data that afford a meaningful view of the probable state of future competition has been underscored by antitrust enforcement agencies and officials. *See, e.g.,* Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, April 2, 1992, §1.41 ("Market shares will be calculated using the best indicator of firms' future competitive significance. ...Physical capacity or reserves will be used if it is these measures that most effectively distinguish firms."), and Baxter, *A Justice Department Perspective,* 51 Antitrust L.J. 287, 291 (1982) ("...it is the ability of a company to supply product in the future in which we are really interested").

2 For purposes of this paper, the term VDT is used to refer to all telco-supplied video services.

extensively relied on by courts and regulatory bodies, and explore the competitive impact of MMDS, DBS and VDT on cable operators. The discussion focuses on potential competition simply because it is the extreme case of a small market share. The same points would have even greater force in the case of competitors with small market shares, such as DBS.

The economics of potential competition

A basic principle of economic theory is that firms seek to act in their own self interest. The quality and quantity of goods and services that a firm offers, together with the prices at which they are offered, are chosen to maximize the profits of the firm. (Somewhat more generally, managers are assumed to seek to maximize the value of the firm—the present value of the stream of all future profits.) If it has the ability to do so, a firm will earn greater profits by producing fewer goods and services than society desires and charging higher prices than are warranted by its costs. For most firms, however, any such ability is sharply reduced or eliminated by the presence of competing firms. When there is competition, an individual firm that raises its prices significantly above the level of costs will find that its profits are reduced as its sales are captured by existing competitors or by new entrants. The threat of losing sales and profits causes firms to keep their prices close to cost.

The primary force that disciplines firm behavior is the threat of losing profits through losing sales to other firms. In many cases, excessive prices would cause sales to be lost to existing firms that offer products that purchasers view as substitutes. In some cases, however, a firm's behavior is disciplined even though few good substitutes are immediately available. A firm may know that if it were to significantly increase the price of its products, other firms not now offering substitute products would quickly "enter" and begin to do so. These entering firms could be firms that currently offer these substitute products in other geographic areas, firms with relevant abilities gained from producing related products, or new firms organized to take advantage of a profitable opportunity. Firms that could enter, though not current competitors, act as "potential competition" that threatens to take away a firm's sales. Potential competition is a strong disciplining force in the American economy. It frequently reinforces current competition, and under the right conditions can take the place of current competition.

One guide in determining whether a firm faces effective competition is to measure what portion of its potential customers are purchasing substitute products. If substitute products have a significant "market share" of sales, one may conclude that current competition will act to discipline a firm's behavior. While a significant market share for substitutes may be an indicator of current competition, it may not reflect accurately the competitive significance of smaller or "fringe" firms, and it may not measure the effect of potential competition on the pricing behavior of firms.

The effectiveness of potential competition can be indicated in several ways. First, even when substitute products have a relatively low market share, potential competition can be effective if the sales of substitute products could be quickly expanded. Expansion possibilities will be related to the capacity of existing facilities or in some cases the time and expense involved in increasing capacity. Second, firms offering competing products in other geographic areas may be likely candidates to enter a new market in response to high prices. This is particularly true when firms plan to expand their geographic coverage and can adjust their plans to include the most profitable areas. Third, potential competition is more likely to be effective when a new firm or one operating in other geographic areas can enter relatively quickly with relatively low start-up costs.

Potential competition in economic theory, antitrust and regulation

Joe S. Bain, often considered the founder of industrial organization economics, emphasized the effect of entry and potential competition on firms that might otherwise face little competition. Bain wrote:

> There will thus be a sort of "recognized interdependence" of actions not only among established sellers but between established sellers and potential entrants. In this event, variations in the condition of entry may be expected to have substantial effects on the behavior of established sellers, *even though over long intervals actual entry seldom or never takes place*.[3]

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3 Joe S. Bain, *Barriers to New Competition*, Cambridge MA: Harvard University Press, 1956, pp. 3-4. Emphasis in the original.

The role of potential competition has become an accepted part of economic theory:

> The basic point is simple and well recognized: The exercise of market power by incumbent firms is constrained by the ability of new firms to enter their market....There is little disagreement among economists on the theoretical proposition that the presence or absence of potential entry may influence actual competition....[4]

In their widely-cited treatise on antitrust, Areeda and Turner acknowledge the importance of entry or potential competition:

> With low or negligible barriers to entry, significant monopolistic pricing will be of relatively limited duration, either because new entry will erode it or because sellers may price near competitive levels in order to deter entry.[5]

The U.S. Department of Justice and the Federal Trade Commission also recognize the importance of potential competition. Their 1992 joint statement on policies for enforcement of the merger laws includes the following:

> A merger is not likely to create or enhance market power or to facilitate its exercise, if entry into the market is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.[6]

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4 John J. McGowan, "Mergers for Power or Progress?" in *Antitrust and Regulation: Essays in Memory of John J. McGowan*, ed. Franklin M. Fisher, Cambridge, MA: The MIT Press, 1985, pp. 6-7.

5 Phillip Areeda and Donald F. Turner, *Antitrust Law: An Analysis of Antitrust Principles and Their Application*, Boston: Little, Brown and Company, 1980, vol. 4, §917a, p. 85.

6 Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, April 2, 1992, § 3.0.